Case Western Reserve Law Review

Volume 10 | Issue 1

1959

Negotiable Instruments--Purchaser in Good Faith

Alan Zuckerman

quest of a party who breaches a legal contract and then seeks custody of the child so as to perpetuate the breach. The same thought is found in the dissenting opinion of *Martin v. Martin*:[24]

> Although the child's welfare is a paramount consideration in every custody case, we cannot close our eyes to fundamental principles as to judgments and agreements, and we cannot forget ancient maxims denying equitable relief to suitors whose hands are unclean.

CONCLUSION

Statutes requiring that strong consideration be given to the religion of the child in granting custody are prevalent in the United States.[25] Their number indicates a widespread approval of the belief that protection of religion is relevant in custody actions.[26] Where it appears that, if granted custody, the promisor will breach the contract, the court should weigh this as a reason for awarding custody to the promisee, if otherwise qualified. This would decrease the need for litigation as court enforcement of the promise would be unnecessary. If the promisor, upon a termination of the marital status, has custody of the child and breaches the contract the courts would do well to consider the merits of enforcement in each particular case and refrain from denying relief automatically. There are obstacles hampering judicial enforcement, but they are not as formidable as they appear at first blush. Equity should seek to do justice, and not refrain from extending its benefits merely because earlier courts have denied relief.

JAMES F. SWEENEY

Negotiable Instruments—Purchaser in Good Faith

The concept of "good faith" is found throughout the law, and it is a particularly essential doctrine in the law of negotiable instruments. Specifically, it is used to determine in part, the question of whether or not a

24. 308 N.Y. 136, 123 N.E.2d 812 (1954). *But see, Denton v. James,* 107 Kan. 729, 193 PAC. 307 (1920) where such conduct was held to be not unconscionable.

25. Forty-three jurisdictions have statutes of this nature. For an analysis of the Statutes in this area see Note, 54 COLUM. L. REV. 376, 396 (1954).

26. In Hackett v. Hackett, 150 N.E.2d 431 (Ohio App. 1958) the appellant (promisee) argued that OHIO REV. CODE §§ 2151.32 and 3107.05, concerning religion in adoption and guardianship matters, expressed a public policy of the state that provisions providing for religious training are to be enforced. The court dismissed this argument on the ground that since custody had already been awarded to the promisor, the code sections were inapplicable.

purchaser of a negotiable instrument is a holder in due course. We are concerned here with the transaction by which the instrument came into the hands of the holder, and not with the facts which constitute the infirmity or defect. Of course, where there is actually no infirmity or defect, the conduct of the taker and his frame of mind at the time of the transfer to him are unimportant.[1]

The question of what is good faith, however, is not readily answered, for what criteria are to be used to determine the state of a man's mind? Is the standard to be wholly "subjective" (what was he actually thinking), or must objectivity, of necessity enter the picture?

HISTORICAL NOTE

The early common law was "clear" in that it established that only "bad faith" would deprive a purchaser of a negotiable instrument of the status of a holder in due course.[2] But in 1824, in the case of *Gill v. Cubit*,[3] this seemingly settled state of affairs was upset, and the suspicious circumstances test was promulgated. Under that rule, if the purchaser took under circumstances of "suspicion" he took subject to the prior defenses and equities of the maker. In 1834,[4] *Gill v. Cubit* was overruled, and the rule of gross negligence was instituted. Unless gross negligence could be shown, even though the purchaser took under "suspicious" circumstances or want of care, prior equities and defenses were of no avail. Finally, *Goodman v. Harvey*[5] set the rule back to 1801, when again "bad faith" became the test.

In the United States throughout this period, both lines of cases developed, and the conflict was not "settled" until the adoption of the Negotiable Instruments Law.[6]

The NIL was the first of the uniform acts to appear in the United States. It was essentially modeled after the English Bills of Exchange Act, but is broader in scope, being applicable to all negotiable instruments generally.

The intent in enacting the NIL was to attain a greater certainty in the law, thereby reducing the volume of litigation plaguing the courts. This has been accomplished to a very considerable degree, but unfortunately there are areas of uncertainty which still exist. A prime example

1. Rightmire, *The Doctrine of Bad Faith in the Law of Negotiable Instruments*, 18 MICH. L. REV. 355 (1920).
2. Lawson v. Weston, 4 Esp. 56 (1801).
3. 3 B. & C. 466 (1824).
4. Crook v. Jadis, 5 B. & Ad. 909 (1834).
5. 4 Ad. & El. 870 (1836).
6. BRITTON, BILLS AND NOTES § 100 at 409 (1943).

of this uncertainty is the question of good faith in section 52 and 56 of the NIL.

THE NIL

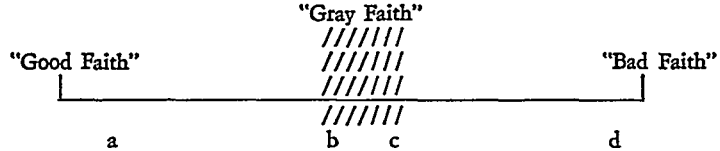
§ 52 A holder in due course is a holder who has taken the instrument under the following conditions:
. . . 3. That he took in good faith. . . .
4. That at the time it was negotiated to him he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it.

§ 56 To constitute notice of an infirmity in the instrument, or defect in the title of the person negotiating the same, the person to whom it is negotiated must have had actual knowledge of the infirmity or defect, or *knowledge of such facts* that his action in taking the instrument amounted to bad faith. (Emphasis added)

A major problem confronting the courts under the NIL is what *is* knowledge of such facts as amounts to bad faith?

a. *"Suspicion" As Bad Faith*

"Suspicion" does not, and cannot have any one, absolute meaning,[7] yet suspicion as bad faith has been widely discounted in the United States. It must be understood that *all* circumstances (short of actual knowledge) justifying charges from good to bad faith can be labeled "suspicion." For example, willful ignorance or facts sufficient to put one on inquiry are really nothing more than *degrees* of suspicion. Perhaps this can best be shown by placing the word "suspicion" on a diagram.



Illust. 1. Suspicion: its degrees of meaning. Point a, slight suspicion, point b, inquiry notice, point c, willful ignorance, point d, actual knowledge.

Somewhere within the shaded area, good faith changes to bad faith — but where? Suspicion has been defined by Black's Dictionary as "the apprehension of something without proof or upon slight evidence"[8] (point *a* above), and by the Restatement of Restitution as "an advertence to facts and such belief as to the existence of facts that the person having

7. Probert, *Law, Logic and Communication*, 9 WEST. RES. L. REV. 129, 138 (1958).

8. BLACK, LAW DICTIONARY 1616 (4th ed. 1951).

it acts in bad faith, where acting with knowledge would be action in bad faith."[9] (points *b* and *c*).

It is quite clear that under Black's definition (which for convenience will be labeled suspicion$_1$) suspicion does not amount to bad faith. Thus it has been said that "mere suspicion or knowledge does not prevent a transferee of a negotiable instrument from becoming a holder in due course unless failure to inquire amounts to bad faith";[10] negligence and suspicious circumstances, though bearing, are not conclusive upon the question of good faith."[11]

Under the Restatement definition, (which I will label suspicion$_2$) however, the situation is not so clear. This can be likened to willful ignorance, or facts sufficient to put one upon inquiry. "One having knowledge of facts exciting such suspicions as to note that he fears to make investigation, lest it may disclose a defense, is not a purchaser in good faith."[12]

An investigation into the facts of the particular cases in the area illustrate the problem. In *Estate of Netherlands v. Federal Reserve Bank of New York*,[13] an American citizen claimed to be a holder in due course as against the Dutch government. The American had purchased bonds from Swiss bankers shortly after World War II, which bonds had been looted by the Germans and sold on the black market in Paris. The American purchased the bonds at a 14% discount. The bonds still bore interest coupons for a number of years, yet he made no investigation of the brokers or any of the other circumstances. The court held that "one who suspects or ought to suspect is bound to inquire (suspicion$_2$), and the law presumes that he knows whatever proper inquiry would disclose. Failure to investigate further can only be explained as willful evasion of his duty of inquiry into those matters which he knew or had reasonable cause to suspect would show a defective title in the seller." Thus is pointed up the willful ignorance or cogent circumstances test. *Sasner v. Ornstein*[14] further exemplifies the above test. The check in question was given in payment of a gambling debt, payment for which had been

9. RESTATEMENT, RESTITUTION § 10 Comment (1937).

10. Anderson Nat'l. Bank of Lawrenceburg, Ky. v. Jacobson, 305 Ill. App. 169, 27 N.E.2d 296 (1940) (dictum).

11. Sonaband v. Chanon, 86 N.H. 386, 169 Atl. 589 (1933).

12. Iowa Nat'l. Bank v. Carter, 144 Iowa 715, 123 N.W. 237 (1909); see also Daniel v. First Nat'l. Bank of Birmingham, 228 F.2d 803 (5th Cir. 1956); Soma v. Handrulis, 277 N.Y. 223 (1938); Hanley v. Epstein, 107 Pa. Super. 507, 164 Atl. 122 (1933); Fenner v. American Surety Co., 156 S.W.2d 279 (Tex. Civ. App. 1941).

13. 99 F. Supp. 655 (S.D. N.Y. 1951), *modified on appeal*, 201 F.2d 455 (2d Cir. 1953).

14. 93 Cal. App.2d 467, 209 P.2d 44 (1949).

stopped by the defendant. There was evidence to the effect that the plaintiff knew that the defendant was gambling, that in fact he had watched the game in progress. The court held that while there was no evidence that the plaintiff had actual knowledge that the consideration for the check was illegal, there was sufficient justification in concluding that the surrounding circumstances were so cogent and obvious that for him to remain passive and make no inquiry amounted to bad faith.[15]

Cases of suspicion$_2$ therefore, include willful ignorance, cogent circumstances, and facts sufficient to put upon inquiry. All are at least evidence of bad faith.

Examples of suspicion$_1$, the apprehension of something without proof or upon slight evidence, are also numerous. In *Sherwood Distilling Co. v. Peoples First National Bank*,[16] the bank discounted a note which it *may* have known was executed in blank — everything else appeared normal. The court held that it is not enough to defeat the rights of one dealing with negotiable instruments to show that he took them under circumstances which ought to excite the suspicions of a prudent man. In another case,[17] a bank took bonds which had been stolen as collateral for a loan, without knowledge of their origin. The bank's officers had knowledge that ten years before, the borrower had been engaged in the gambling business. The defendant claimed that acceptance from a gambler of negotiable bonds, in absence of further inquiry, made the bank act in bad faith. The court held otherwise, saying that "one is not bound at his peril to be on the alert for circumstances which might possibly excite the suspicions of wary negligence."

b. *Word Problems*

A glance at any digest, text, or code annotation will clearly indicate that the cases in this particular area are legion. The courts are struggling

15. In Christian v. California Bank, 93 Cal. App. 2d 230, 208 P. 2d 784 (1949), plaintiff indorsed a check in blank, and then restrictively indorsed it to "Bank of America, S&R Produce Co." Plaintiff's partner took the check to the defendant bank, the bank struck the restrictive indorsement, and deposited it to the partner's personal account. At the time, the defendant knew the partner's account was overdrawn, and was holding a check awaiting deposit. The court charged the bank with failure to inquire, and held therefore, that it was not a holder in due course.

16. 193 F.2d 649 (4th Cir. 1952); see also Gramatan Nat'l. Bank v. Moody, 326 Mass. 367, 94 N.E.2d 771 (1950); Western Surety Co. v. Friederichs, 241 Minn. 492, 63 N.W.2d 565 (1954); McKinnon v. Grenada Bank, 85 So. 2d 458 (Miss. 1956); Witte v. Broz, 111 Neb. 76, 197 N.W. 121 (1923); Hall v. Bank of Blasdell, 306 N.Y. 336, 118 N.E.2d 464 (1954); Citizens Bridge Co. v. Guerra, 152 Tex. 361, 258 S.W.2d 64 (1953).

17. Manufacturers and Traders Trust Co. v. Sapowitch, 296 N.Y. 226, 72 N.E.2d 166 (1947).

to frame a rule in its simplest terms — at least for purposes of a jury charge. The question usually comes out — "When is a man put upon inquiry?", and the answer, "When it would be bad faith not to inquire." But bad faith is the ultimate thing to be found in these cases, so what we have is a beautiful case of circular reasoning.[18]

Perhaps Hayakawa, the eminent semanticist, best exemplifies this with what he calls "chasing oneself in verbal circles":[19]

> 'What do you mean by *democracy?*'
> 'Democracy means the preservation of human rights.'
> 'What do you mean by *rights?*'
> 'By rights I mean those privileges God grants to all of us — I mean man's inherent privileges.'
> 'Such as?'
> 'Liberty, for example.'
> 'What do you mean by *liberty?*'
> 'Religious and political freedom.'
> 'And what does that mean?'
> 'Religious and political freedom is what we have when we do things the *democratic* way.'

But, must there be a rule, and is it necessary or *possible* to lay down any particular definition? The words "bad faith," "good faith," "suspicion," etc., cannot possibly bring the same response from all observers.

Thus as Britton states[20] ". . . [I] t is most unlikely that all trial courts will act with reference to all issues presented in accordance with identical conceptions of bad faith. There is present in all cases, therefore, an element of choice, a variable factor which cannot be solved out."

"This is because the emotional reactions [conceptual predispositions] of the lawyer who advises on their [its] application is not necessarily the same as that of the judge or jury who finally determines the matter. . . ."[21]

What we have therefore, is the use of "emotive" words in this highly important area of the law. "Such words call for a feeling of approval or for side taking, and that is about all."[22] The net result with the "honesty in fact" or "subjective" test which the NIL codifies in section 56, is that the courts are bogged down with value judgments which pass in legal terminology under the name of question of fact, and are left to the jury to settle.[23] The measure of control over the jury which instructions are

18. Rightmire, *The Doctrine of Bad Faith in the Law of Negotiable Instruments*, 18 MICH. L. REV. 355 (1920).

19. HAYAKAWA, LANGUAGE AND THOUGHT IN ACTION at 173 (1949).

20. BRITTON, BILLS AND NOTES § 101, at 414 (1943).

21. Williams, *Language and The Law*, 62 L. QUART. REV. 387, 401 (1946).

22. Probert, *Law, Logic and Communication*, 9 WEST. RES. L. REV. 129, 141 (1958).

23. Williams, note 21, *supra.*

supposed to provide, is therefore lost, because of the lack of communication and the relative impossibility of determining what is *actually* in a man's mind.

A similar example of the "subjective" test is encountered in the criminal law, *i.e.*, the principle of *mens rea*, or guilty mind. Ordinarily, a crime consists of a combination of a criminal act and a criminal intent *(mens rea)*. There is a modern trend developing, however, which has been called the "eclipse of *mens rea*," and by statute, the requirement of *mens rea* is gradually being eliminated. As a test *mens rea* is a difficult, if not impossible one to apply, since the courts "lack the omniscience of the Diety," and must often resort to presumptions concerning the mental element of intent.[24] "It is a general rule that every man of sufficient mental capacity to know what he is doing is presumed to have intended the natural or probable consequences of his voluntary acts."[25] (The presumption is rebuttable, however.) The "reasonable man" test in tort law is a further example of the "subjective test" and the difficulty encountered with its use.

Thus it can be seen that even on the hallowed grounds of criminal responsibility, the subjective test is giving way, often because of the difficulty of proof, and perhaps because the legislatures are more realistic than are the courts. But the legislatures have not answered the same problem which exists in the "good faith" area of negotiable instruments. The Uniform Commercial Code which modifies the NIL definition, provides a standard by which the jury can determine the question of good faith.

THE UNIFORM COMMERCIAL CODE

Some of the problems existing under the NIL were created by poor draftsmanship, others because the act has been ignored in favor of common law decisions, and still others because of inadequate analysis of the various sections of the act by the courts.[26] The NIL has served us well, but the UCC was created in part to overcome some of the difficulties and clarify situations which were not apparent when the original NIL was adopted. The UCC is a carefully considered, well drafted code, a product from some of the best legal scholars in the United States today.[27] Section 3-302 is an attempt to deal with the problem of good faith; it is

24. CLARK AND MARSHALL, CRIMES § 44, at 68 (5th ed. 1952).

25. *Ibid.*

26. BRITTON, BILLS AND NOTES § 3, at 19 (1943).

27. NEW YORK LAW REVISION COMMISSION, *Report and Record of Hearing on the Uniform Commercial Code* Legisl. Doc. No. 64, p. 23 (1954).

a suggested solution that was created with the benefit of countless cases which have come before the courts since the adoption of the NIL.

> § 3-302: A holder in due course is a holder who takes the instrument: . . . (b) in good faith *including observance of the reasonable commercial standards* of any business in which the holder may be engaged. . . . (Emphasis added)
>
> Comment: . . . A businessman engaging in a commercial transaction is not entitled to claim the peculiar advantages which the law accords the good faith purchaser . . . on a bare showing of 'honesty in fact' when his action fails to meet the generally accepted standards current in business, trade, or profession. . . .[28]

The great objection to this section is that an "objective" standard has been re-introduced into the law of negotiable instruments, and a fear of a return to the standard of *Gill v. Cubit.*

From a reading of the New York Hearings on the UCC,[29] it is clear that this was not the intent. Call the proposed standard "objective," or "subjective," or call it neither. The important point is that something more readily susceptible of "proof" is introduced rather than merely "honesty in fact," or "good faith" alone. It presents to the jurors something to hang their hats on, and removes somewhat the involvement of emotion in their decision. In short, it is an attempt to set up a standard by which to judge "honesty in fact," or to prove "good faith." There is no attempt, as the drafters explain it,[30] to return to the standard of the reasonably prudent man.

Perhaps the language of the UCC is susceptible of the reasonably prudent man interpretation. However, this is no reason to abandon all attempt to give clarity to a befuddled area, as was done in the latest draft of the UCC, in which the reasonable commercial standards test was dropped.[31] This was no doubt due to the formidable objection presented in testimony before the New York Law Revision Commission.

An attempt to keep the status quo, however, is not an answer to the problem, despite the outcries of many of the writers.[32] Perhaps we must await the outcome of the actual use of the UCC in Pennsylvania, before we can determine whether the present objections are valid — a field test will, no doubt, give both the proponents and opponents a more substantial basis on which to argue.

ALAN ZUCKERMAN

---

28. UNIFORM COMMERCIAL CODE (1952); See also Husseyni v. Rappaport, 127 F. Supp. 144 (D. Minn. 1954).

29. NEW YORK LAW REVISION COMMISSION, note 27, *supra,* at 213, 240, 521.

30. *Ibid.*

31. UNIFORM COMMERCIAL CODE § 3-302 (1957).

32. Britton, *Holder in Due Course — A Comparison of the Provisions of the Negotiable Instrument Law with Those of Article 3 of the Proposed Uniform Commercial Code,* 49 NW. U. L. REV. 417, 430 (1954).